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Arizona Corporation Commission
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July 13, 2012

HAND-DELIVERED

Chairman Gary Pierce
Commissioner Bob Stump
Commissioner Sandra Kennedy
Commissioner Paul Newman
Commissioner Brenda Burns
ARIZONA CORPORATION COMMISSION
1200 West Washington Street
Phoenix, Arizona 85007

Re: Proposed Policy Statement on Income Tax Expense for Pass-Through Entities (In the Matter of the Commission's Generic Evaluation of the Regulatory Impact from the Use of Non-Traditional Financing Arrangements by Utilities and their Affiliates, Docket No. W-00000C-06-0149)

Dear Chairman and Commissioners:

On June 15, 2012, Chairman Pierce filed a proposed Policy Statement on Income Tax Expense for Tax Pass-Through Entities in Docket W-00000C-06-0149. The proposed policy states, in part, as follows:

> Based upon the evidence and testimony which has been presented in the recent rate cases before this Commission as well as in the generic docket, we are persuaded that a tax pass-through entity should be allowed to recover income tax expense as a part of its cost of service and that its revenue requirement should be grossed up for the effect of income taxes. We are persuaded that the failure to include income tax expense needlessly discriminates against tax pass-through entities and creates an artificial impediment to investment in utility infrastructure. Neither of these outcomes serves the interests of rate payers. Thus, we will adopt a new policy which allows imputed income tax expense in the cost of service for limited liability companies, Subchapter S corporations and partnerships. While sole proprietorships are not technically tax pass-through entities, the arguments supporting the inclusion of income tax expense for tax pass-through entities are equally applicable in the case of sole proprietorships. Thus, the policy will apply to sole proprietorships as well as tax pass-through entities.

Johnson Utilities, LLC ("Johnson Utilities" or the "Company") fully supports the proposed policy statement as it is drafted and urges the Arizona Corporation Commission ("Commission") to adopt the

policy statement at the earliest opportunity. Utilities which are subchapter C-corporations and utilities which are tax pass-through entities such as subchapter S-corporations, limited liability companies and partnerships all generate income from their utility operations which must be taxed. In the case of a subchapter C-corporation, the tax liability is satisfied by the corporation itself. In the case of a pass-through entity, the tax liability is satisfied by the owner(s) of the pass-through entity. In either case, however, the tax liability associated with the income of the utility must be satisfied.

The Chairman's proposed policy statement properly recognizes that there is no reasonable basis to support the current dichotomous policy of allowing income tax expense in the cost of service of C-corporations while simultaneously disallowing income tax expense in the cost of service of S-corporations, limited liability companies and partnerships.[1] If adopted, the proposed policy statement would place the Commission in harmony with the latest pronouncement of the Federal Energy Regulatory Commission ("FERC") on the subject of income tax expense for tax pass-through entities. As stated by Utilities Division Staff ("Staff") in its Supplemental Staff Report dated June 27, 2012:

> On May 4, 2005, the Federal Energy Regulatory Commission ... reversed its previous position and decided to allow recovery in rates for income tax expenses that are "attributable to regulated service." FERC concluded that "a taxpaying corporation, a partnership, a limited liability corporation, or other pass-through entity would be permitted an income tax allowance on the income imputed to the corporation, or to the partners or the members of pass-through entities, provided that the corporation or the partners or the members, have an actual or potential income tax liability on that public utility income."[2]

Johnson Utilities has reviewed the Supplemental Staff Report dated June 27, 2012, and will address below certain erroneous assertions contained therein. However, as an initial comment, Johnson Utilities agrees with Staff that the imputation of income tax expense as a component of the revenue requirement for tax pass-through entities is a policy issue for the Commission to decide. The Commission is constitutionally endowed with broad power to set rates and charges for public service corporations. Article 15, Section 3 of the Arizona Constitution states, in relevant part, as follows:

> The corporation commission shall have full power to, and shall, prescribe just and reasonable classifications to be used and just and reasonable rates and charges to be made and collected, by public service corporations within the state for service rendered therein, and make reasonable rules, regulations, and orders, by which such corporations shall be governed in the transaction of business within the state, and may prescribe the forms of contracts and the systems of keeping accounts to be used by such corporations in transacting such business, and make and enforce reasonable rules, regulations, and orders for the convenience, comfort, and safety, and the preservation of the health, of the employees and patrons of such corporations....

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[1] The proposed policy statement would also apply to sole proprietorships. Johnson Utilities agrees that the policy should apply to all pass-through tax entities and sole proprietorships. Hereinafter, these entities are collectively referred to as "pass through entities."

[2] Supplemental Staff Report (June 27, 2012) at 1 (*citing* Policy Statement on Income tax Allowances at pp. 12-13, ¶¶ 32-33, 111 FERC ¶ 61,139 (2005)).

Arizona case law is clear that the Commission has the authority to allow the recovery of income tax expense in utility rates and that the decision is the Commission's to make. In *Consolidated Water Utilities, Ltd. v. Arizona Corp. Comm'n*, 178 Ariz. 478, 875 P.2d 137 (Ct. App. 1993), the Arizona Court of Appeals ruled as follows:

> In Arizona, the decision to allow or disallow that tax expense is to be made by the Commission, not the courts. *See also Tucson Gas*, 15 Ariz. at 306, 138 P. at 786 (the Commission has exclusive power over rate cases, and this "exclusive field may not be invaded by the courts, the legislative or executive.").

Thus, there is no doubt that the Commission has authority under the Arizona constitution to include income tax expense when setting the rates and charges for tax pass-through entities.

While Staff correctly acknowledges that the question of income tax expense is an issue for the Commissioners to decide, the Company strongly opposes Staff's recommendation to continue the current policy of excluding income tax expense for pass-through entities. The current policy arbitrarily discriminates against pass through entities, including Johnson Utilities, based solely upon a utility's choice of a corporate form. The result of this discrimination—all other things being equal—is that S-corporations, limited liability companies and partnerships receive a lower revenue requirement and operating income than their C-corporation counterparts, and therefore, a lower rate of return. Rate-making should be applied in a manner which produces reasonable and realistic results, regardless of the legal form of the utility.

Staff erroneously focuses on who pays the income tax, rather than on the fact that income from utility operations creates tax liability. There is no question—and Staff does not deny—that the income of a pass-through entity creates tax liability just as the income of a C-corporation creates tax liability. In the case of a C-corporation, the corporation itself satisfies the tax liability whereas in the case of a pass-through entity, the owner(s) of the pass-through entity satisfy the tax liability. In either case, the income generated by utility operations creates tax liability that must be satisfied. Because the income of both C-corporations and pass-through entities creates tax liability, each form of utility is entitled to income tax expense in its cost of service. There is simply no reasonable or equitable basis for treating the two differently.

The following example illustrates the fundamental inequity of the current policy on income tax expense. No one would deny that an existing utility formed as a limited liability company could be converted to a subchapter C-corporation at the option of the utility's owner(s). If such a conversion were to occur, the new C-corporation would be entitled to income tax expense in its cost of service under the Commission's current policy, even though nothing else about the utility changed except for its legal form. Certainly, ratepayers gain nothing by forcing a utility to convert to a C-corporation and there may actually be negative impacts to such a conversion.[3] The inclusion or exclusion of income tax

[3] The Commission's policy on income tax expense should not drive a utility's decision to incorporate as a C-corporation versus a pass-through entity. There are good reasons why a new utility may want to incorporate as a limited liability company, a partnership or an S-corporation. For example, the operating losses of a pass-through entity flow immediately to the owner(s) of the utility and may be offset against other income. Such losses provide the owner(s) with additional cash flow during the critical early years of a utility. Additionally, formation of a pass-through entity avoids the double taxation which can occur in the case of a C-corporation. Thus, pass-through

expense should not hinge on the legal form of a utility, but rather, should be based on whether or not it is fair and non-discriminatory. Fundamental fairness requires that where income tax expense is allowed for C-corporations, it must likewise be allowed for pass-through entities.

Staff argues that "[p]roviding for income tax expense for taxes paid by the recipients of pass-through income would be analogous to paying for taxes borne by shareholders of C Corporations for dividends received and places an unfair burden on the ratepayers."[4] Staff goes on to state that "[s]uch treatment effectively increases the rate of return to investors in excess of the stated, or intended, authorized rate."[5] In fact, neither of these assertions is true. First, allowing income tax expense for pass-through entities is in no way analogous to allowing income tax expense for the shareholders of a C-corporation. Subchapter C-corporations incur tax liability at the corporate level and then the shareholders of the corporation incur tax liability on any dividends that are paid—the so-called "double taxation" of a C-corporation. If the Commission were to allow income tax expense to pay the dividend taxes of the shareholders of a C-corporation, then the rate payers of the C-corporation would pay two tax expenses—one for the taxes of the corporation (which ratepayers already pay in their cost of service) and one for the taxes of the shareholders.[6] Making rate payers pay tax twice would place an unfair burden on rate payers, and nobody is suggesting that such should be the case. Under the current policy, pass-through entities are not allowed any income tax expense, so the customers of pass-through utilities enjoy an unfair windfall because they avoid income tax expense in their rates while the customers of C-corporations pay tax expense in their rates. Adopting the proposed Policy Statement on Income Tax Expense for Tax Pass-Through Entities places all utilities (and all utility customers) on an equal footing, regardless of the corporate form of the utility, by ensuring that all ratepayers pay an appropriate income tax expense as a part of the cost of their utility service.

Second, Staff errs when it states that including income tax expense for tax pass-through entities increases the rate of return above the authorized rate. Quite to the contrary, failing to include income tax expense in the cost of service of pass-through entities virtually guarantees that the pass-through entity will under-earn its authorized rate of return. For example, an authorized 10% rate of return for a tax pass-through entity is necessarily less than an authorized 10% rate of return C-corporation because one is a before-tax return and the other is an after-tax return. Adopting the proposed Policy Statement on Income Tax Expense for Tax Pass-Through Entities ensures equity in the authorized rates of return of C-corporations and tax pass-through entities.

Staff recommends that if the Commission adopts the proposed policy statement and allows income tax expense in cost of service for tax pass-through entities, it should adopt certain minimum conditions/requirements as outlined in the Supplemental Staff Report. Johnson Utilities discusses each of Staff's proposed conditions below.

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entities are typically more tax efficient than C-corporations. The Commission's current policy on income tax expense, however, acts as a substantial deterrent to formation as a pass-through entity.

[4] Supplemental Staff Report (June 27, 2012) at 2.

[5] *Id.* at 3.

[6] There is another defect in Staff's argument and that is that it assumes that a C-corporation actually pays a dividend to its shareholders. Of course, C-corporations have no obligation to pay dividends to shareholders and some do not. Even in those cases where a C-corporation pays dividends, those dividends constitute only a fraction of the corporation's income. The owners of a pass-through entity, on the other hand, have tax liability for 100% of the income of the pass-through entity, regardless of whether or not the pass-through entity actually distributes cash to the owners.

A. A requirement that the regulated entity provide detailed information about its owners, to include the number and type of owners and each owner's pro-rata share of regulatory income.

Johnson Utilities does not oppose this condition/requirement. This type of information is required in order to determine the appropriate tax expense to include in the cost of service of a pass-through entity.

B. A requirement that the regulated entity provide copies and supporting documentation, as deemed necessary by Staff, of each owner's income tax returns for the past three years so that an effective tax rate can be calculated for each owner's share of the regulated income. If any owner of the regulated entity is another S-Corp or LLC, that owner must provide copies of all requested tax returns for each direct and indirect recipient of income from the regulated entity. In the event that information is not received or is inadequate to calculate each member's personal tax rates, the default rate for the portion of the imputed income tax expense shall be zero.

Johnson Utilities opposes this condition/requirement because the Commission does not need (and it is inappropriate to require) the individual tax returns of the owner(s) of a pass-through entity in order to calculate the appropriate tax expense according to the method set forth in the proposed Policy Statement on Income Tax Expense for Tax Pass-Through Entities. The information listed in condition/requirement "A" above, together with other information that is filed with a rate case, is sufficient to allow Staff to verify the appropriate income tax expense for a pass-through entity. Moreover, whether the parent company of a C-corporation or the owner(s) of a pass-through entity, the actual income taxes paid in a given year can vary substantially from other years depending upon the other income and deductions that are applicable. Further, the current policy for C-corporations is to determine the income tax allowance for the utility on a stand-alone basis, thereby eliminating any potential for cross-subsidization between utility operations and non-utility operations. The same is true for the owner(s) of pass-through entities. Only the utility income from the pass-through entity should be considered in determining the effective tax rate used to compute the income tax allowance. The other income and deductions of the owner(s) should not be considered because to do so would result in cross-subsidization. Thus, reviewing personal tax returns serves no meaningful purpose in the determination of the effective tax rate for the utility, whether for a C-corporation utility or a pass-through utility. It is also important to note that past tax returns will not match up with the test year in any event.

C. A requirement that each owner file proof of payment for Federal and State income tax return liability for returns filed in compliance with item b above. If proof of payment is not provided or is not available, the owner may file a notarized, sworn statement attesting that the tax returns filed are a true and accurate copy of the tax returns filed with the taxing authority.

Johnson Utilities opposes this condition/requirement as it is written. However, Johnson Utilities would agree to provide a Certificate of Compliance and Letter of Good Standing from the Arizona Department of Revenue at the time of filing a rate case certifying that all income tax returns for the Company have been filed. For the reasons discussed above, actual copies of tax returns of the owner(s) of a pass-through entity are not needed to determine the appropriate income tax expense for the utility and, therefore, should not be required.

D. A determination that the regulated entity be authorized a lower rate of return on rate base. Since an income tax allowance for S-Corps and certain LLCs provides tax-free utility income to the shareholders/members, a lower rate of return is warranted to reflect the "tax-free" status of that income in a manner similar to the lower yield of tax-free versus taxable bonds with the same rating.

Johnson Utilities opposes this condition/requirement. There is no more reason to lower the rate of return of a pass-through entity which receives income tax expense than there is to lower the rate of return of a C-corporation which receives income tax expense. Moreover, as discussed above, the failure to allow income tax expense in the cost of service of a pass-through entity actually penalizes the pass-through entity with a lower rate of return than a similarly situated C-corporation, all other things being equal. It should also be noted that Staff's use of the phrase "tax free" to describe the income of a pass-through entity is inaccurate. The mere fact that the owner(s) of a pass-through entity pay the tax liability on the utility income as opposed to the pass-through entity itself does not render the income "tax free."

Johnson Utilities supports the written comments of Arizonans for Responsible Water Policy dated July 2, 2012, and filed in the above-captioned docket on July 3, 2012.

In conclusion, the policy statement proposed by Chairman Pierce is consistent with the well-reasoned policy adopted by FERC in 2005 and reinstates a former Commission policy (one which was previously supported by Staff) which allowed income tax expense in the cost of service of tax pass-through entities. Johnson Utilities fully supports the proposed Policy Statement on income Tax Expense for Tax Pass-Through Entities as drafted and urges the Commission to adopt the policy at the earliest possible opportunity.

Very truly yours,

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